Twitter Thread by Zen Black



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1/ Thread: "A Silicon Valley Ponzi Scheme"

Thanks to @chamath for laying this out in Social Capital's 2018 annual letter.

I've always appreciated his outspokenness.

2/ The hardest thing for most startups today is the path to market: first finding product-market fit & a way to reach customers, then building a ruthless machine to acquire, monetize & retain them.

3/ Because of this, when the VC industry invests capital into fast growing startups today, the plurality (if not majority) of invested capital will go into user acquisition and ad spending, for better or worse— usually worse.

4/ Todays massive venture-backed advertising, sales, and user acquisition playbook has morphed into one that champions growth at any cost.

This is creating a big bill that will soon come due...

5/ Ad impressions and click-throughs are bid up to outrageous prices by startups flush with venture money, and prospective users demand more and more subsidized products to gain their initial attention.

6/ As growth becomes increasingly expensive, somebody must be footing the bill for all of this wasteful spending.

But it's not who you think (that does), and the dynamics we've entered is in many ways creating a dangerous, high stakes Ponzi scheme.

7/ Over the past decade a subtle and sophisticated game has emerged between VCs, LPs, founders and employees.

Someone has to pay for the outrageous costs of this style of growth. Will it be VCs?

Likely not.

8/ They get paid to allocate other people's (LPs) money, and they are smart enough to transfer the risk.

Eg: VCs habitually invest in one another's companies during later rounds, bidding up rounds to valuations that allow for generous markups on their funds' performance.

9/ These markups (& paper returns they suggest) allow VCs to raise subsequent, larger funds, and to enjoy the management fees that those funds generate.

if you're a VC with a $200 million dollar fund, you're able to draw $4million each year in fees.

10/ Typical venture funds pay out 2 percent per year in management fee plus 20 percent of earned profit in carried interest, commonly called "two and twenty".

Most funds never return enough profit for managers to see a dime of carried interest.

11/ Instead, management fees are how they get paid.

If u can show marked up paper returns & then parlay those returns into a newer, larger fund—say $500 million—you now have a fresh $10 million a year to use as you see fit.

12/ So even if paying or marking up sky-high valuations will make it less likely that a fund manager will ever see their share of earned profit, it makes it ■more■ likely they'll get to raise larger funds, & earn enormous management fees.

There's some deep misalignment here...

13/ There's an analogy to be made between today's venture backed startup ecosystem and the American healthcare industry,

Partly why American healthcare is so expensive is bcos insurers, who play a key middleman role in setting prices for medical care, have a 2-sided biz model:

14/ High prices, which ought to be a cost of doing business for them, are actually a key revenue driver. Why is this?

High costs allow them to charge higher premiums, allowing them to pull steadily more and more money out of patients' and payers' pockets.

15/ As a result, cost of medicine steadily rises, as do the insurers' take.

In the end, both, patients and payers are the ones who end up as bag holders footing the bill.

The same thing is happening in today's venture world.

16/ Highly marked up valuations, which should be a cost for VCs, have in fact become *their key revenue driver*—letting them raise new funds & keep drawing fees.

Just as insurers' biz model translates to higher costs of patient care,

17/ the modern venture model translates into higher costs of just about everything: higher salaries, higher rents, higher customer acquisition costs & kombucha on tap!

So if its not VCs, who ends up holding the bag?

It's still not who you'd expect.

18/ Later-stage funds investing large follow-on rounds into these marked up companies, do indeed pay inflated prices, but also usually get their money out 1st upon a liquidity event & are happy to exist in Fee-landia.

In some cases, high prices may even work to their advantage.

19/ They're able to hold certain late-stage companies hostage to their high valuations by demanding aggressive deal structures in return for granting Unicorn Status: the big *billion* dollar valuation the VCs so crave.

Unlike the other pass-the-buck schemes

20/ the bill is not getting passed from early investors to later investors.

The real bill ends up getting shuffled outta sight to 2 other groups.

The 1st as u may guess are early stage funds' limited partners, particularly future■ limited partners investing into the next fund.

21/ Their money after all pays the VC's newly trumped up mgmt fee.

Marking up Fund IV to raise money for more mgmt fees out of Fund V is so effective bcos fundraising can happen much faster than the long & difficult job of building businesses & creating real enterprise value

22/ It might take seven to ten years to build a company, but raising the next fund happens in two or three years.

The second group of people left holding the bag is far more tragic: the employees at startups.

23/ The trend in SV today is for a large % of employee compensation to be given out in the form of stock options or restricted stock units.

Although originally helpful as a way to incentivize and reward employees for working hard for an uncertain outcome,

24/ in a world where startup valuations are massively inflated, employees are granted stock options at similarly inflated strike prices.

Overall, you can understand how this arrangement endures:

25/ VCs bid up and mark up each others portfolio company valuations today, justifying high prices by pointing to today's user growth & tomorrow's network effects.

Those companies then go spend the money on more user growth, often in zero-sum competition w/ one another.

26/ Today's limited partners are fine with the exercise in the short run, as it gives them the markups & projected returns that they need, to keep their own bosses happy.

27/ Ultimately ■the bill gets handed to current & future LPs (many years down the road), ■and startup employees■■—who lack the means to do anything about the problem other than leave for a new company, & acquire a 'portfolio' of options.

What is the antidote here? Its 2-fold.

28/ First we need to return to the roots of venture investing. The real expense in a startup shouldn't be their bill from Big Tech but, rather, the cost of real innovation and R&D.

The 2nd is to break away from the MLM scheme that the VC-LP-user growth game has become.

29/ @socialcapital has done this by actively shifting away from funds & LPs to rely only on its own permanent capital moving forward.

It's time to wait patiently, as the air is slowly let out of this bizarre Ponzi balloon created by the venture capital industry.

30/ In the meantime, we find comfort in the teaching of Andy Grove that only the paranoid survive.

Thanks for reading.